Final Report

ASSESSMENT OF AND POSSIBLE REDESIGN OF THE CASHBANK LIMITED DCA TRANSACTION

Submitted by:

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TERMS OF REFERENCE

Consultant was requested to undertake a review of the DCA credit manual to gain an understanding of the operation of the programme, and to closely examine the Guaranty Agreement between Cashbank and USAID, highlighting any questions and/or concerns. Consultant was further required to undertake a detailed discussion with Cashbank in order to gain a complete list of institutions contacted by Cashbank and to gain an overview of the difficulties experienced by Cashbank in securing the funds. It was also required that consultant, in conjunction with USAID and Cashbank, identify potential investors and hold further discussions to determine their interest. If necessary, consultant was required to examine the potential for amendments to the DCA programme in order to find a suitable investor/s. This requirement was subject to additional stipulations. The results of these terms of reference were to be encapsulated in a brief report.

SECTION ONE

Consultant has reviewed the Development Credit Authority Operations Manual made available at the commencement of the consultancy, on the basis that this document was the "credit manual" referred to in the Terms of Reference. The role, application and processes that underpin the DCA programme are understood.

The Guaranty Agreement was examined in some detail. Issues that may have given rise to the difficulties experienced are dealt with below, cross referenced to the applicable section of the agreement.

THE PROGRAM (Clause 1)

The borrower is limited in the application of funds to increasing its *mortgage developer and micro-scale housing products*, a market that has generally lost favour with domestic large scale investors in South Africa. While the reasons behind this are partly commercial, a lack of experience and/or reliable market statistics regarding loan performance in this sector begets caution. Investment in this sector by large institutions has been primarily through specially developed banks with support from significant or majority shareholders, who are often banks. Systems and procedures are well tested, and importantly the loan period has shown a significantly shorter profile than that which borrower is starting to reflect. While consultant appreciates the need to provide funding support on a project specific basis, this could have proved counter-productive in this instance.

OBLIGATIONS OF CASH BANK (Clause 2)

By virtue of the project specific nature of the programme, Cashbank (under sub-section A) was required to provide a detailed "Programme

Plan" which deals with issues outside of the actual control of Cashbank. While appreciated that such information is necessary in the planning and execution of a programme of this nature, the incorporation thereof as a part of the DCA Agreement lends form and substance to these requirements as an integral component of the Agreement. Failure by Cashbank to comply with the Programme Plan may, by some, be viewed as a default occurrence, notwithstanding the potential relaxation of the conditions, under defined conditions, as contained in sub-section B. As a matter of record, there exists a spelling error in the agreement, at sub-section E. Sub-section F of the Agreement renders, in consultants opinion, an insurmountable hurdle to Cashbank and investors. Cashbank has funded asset growth by way of secured loans, many of which exist at the time of writing and which have maturity dates, in some instances, beyond that envisaged in the Agreement. By virtue of the pledge of assets, such lenders are constituted as Senior Secured, and by way of the perfection of the security would be preferred to USAID in the event that Cashbank was placed under legal disability. Cashbank further advised consultant that they sought to enhance the potential loans by way of additional security, which would have taken the form of pledged assets.

OBLIGATIONS OF USAID (Clause 3)

In terms of sub-section A, USAID is obligated to pay at "the exchange rate...on the date that each payment is made". In terms of sub-section B, the limit of USD 20 million is reached "calculated at the exchange rate...at the time each Loan is executed". This introduces an element of exchange rate risk, notwithstanding that the domestic currency has not been able to show any appreciation against the United States Dollar of late. While this may be detrimental to the risks assumed by USAID, it may be preferable to stipulate that the guarantee will come into effect as a domestic currency obligation, and will remain as such for the duration of the guarantee period, and such currency shall also be the currency for the lodgement and payment of claims. The obligation should be fixed at the domestic currency level ruling on the day that the loan is entered into/closed.

CONDITIONS PRECEDENT TO USAID OBLIGATIONS

The legal opinions required introduce an element of doubt as to the capacity of Cashbank to enter into such agreements, and should have formed part of the recital. Registration as a bank in terms of the Banks Act should likewise have formed a part of the recital.

SECTION TWO

Cashbank had discussions with, in total, 45 prospective participants. The sector breakdown of those approached was:

Insurance/Pension Sellers	10
Banks	12
Asset Managers	13

Pension Funds	6
Other	4

Of the 45, 4 are/were investors in Cashbank, who at 30 September 2000 represented 15.8% (1999: 25%) of secured long term loans disclosed in the financial statements of Cashbank. In addition, a previous holder of 100% of Negotiable Certificates of Deposit issued by the bank was approached. A full list is provided in annex A to this report.

Consultant was required to hold discussions with the relevant executives of the bank to determine the reasons behind the lack of interest in participation by those approached.

STATED REASONS FOR DECLINE IN INVOLVEMENT.

- The onset of the marketing of this programme was shortly after the failure of two small banks in the domestic market, viz. New Republic Bank and FBC Fidelity Bank. Both of these banks suffered from a loss of market confidence following negative (but in some instances, unsubstantiated), media exposure. However, this highlighted the vulnerability of smaller banks in South Africa. The operations of Cashbank did not, and still do not, provide significant diversity of asset exposure into the corporate as well as the retail sector, providing lessened comfort to potential investors looking for contra-cyclical capacity from the asset base. Clearly, the focus of Cashbank is into the emerging and/or under-banked sectors in the country, where the perception of higher risk is pronounced. Thus, despite the support provided by USAID, the bank was placed squarely in the "small bank sector", and consequently had to face the funding "crisis" which affected the sector.

- Cashbank had not been rated by any of the credit rating organisations in South Africa. Based on the structure and performance of the bank, as well as consultants knowledge of the procedures applied by such agencies, it is unlikely that the bank would have been assigned a rating in the investment grade categories. For information purposes, the domestic money markets place what appears to be a market cut-off at A2 (F2) short-term rating levels when establishing counter-party funding limits. While this appears to ignore the fact that there is one more category in the so-called investment grade scale, this reluctance to invest freely in lower levels is symptomatic of the generally short term nature of (liability) maturities in the domestic financial markets. The bank, probably correctly, perceived little value in having a rating assigned to the bank. Although consultant is aware that asset managers and investors utilise ratings with varying intensity, the lack of a rating in this instance was utilised as a reason for declining participation.

- Cashbank has utilised assets on its balance sheet to secure liabilities in the past. In the marketing of this programme, the bank undertook to secure liabilities to the extent of 50% by way of the USAID programme, and a further 65% by way of assets on their balance sheet, to provide a total of 115% in credit enhancement. Certain respondents highlighted the fact that their operations are not able to accommodate retail account management, and were sceptical of their ability to make use of such security in the event that it was necessary to rely thereon. Two inferences can be drawn from this response, the first being that it was a convenient “reason” and the second was that the respondents had a very real perception that Cashbank would default on the programme. While it can, with a high level of confidence, be anticipated that programme default would have lead to the bank being placed under legal disability and consequently external management, it may be concluded that respondents had a real concern with internal capacity and account management.

- The maturity structure of the programme did not, according to certain respondents, match their required profile. For the record, the initial programme was preferred (by USAID) at 15 years, and subsequently reduced to 8 years. Based on the market in which Cashbank is operative, and the negative perceptions which currently surround this market, those respondents who provided information on maturity indicated that a 3 to 5 year maturity would have been preferred, on the basis that the other negative aspects could be addressed.

- While the operations of Cashbank are not specifically focused on the Government sector, the adverse publicity that surrounded the stated intention of the Government to deny access to the State payroll system for direct payment to lenders was said to have contributed to the decision by numerous respondents to decline involvement.

- Activities by lenders in the lower income market segment have, over the recent past, become less attractive than before. This is not restricted to lending for housing purposes alone, but has generally been tainted by activities in the entire micro-lending sector.

- Pricing of the loan was generous by the interest margin spreads available to Cashbank. In addition, Cashbank was to provide for the costs associated with the USAID DCA programme. Attempts by potential lenders to extract additional spread meant that the facility became uneconomic for Cashbank, and in fact may have lead to potential default. Consultant was also advised that at the time of the announcement of the withdrawing of access to the government payroll system, potential investors indicated that an additional 60 basis points would be required on any participation that they could offer to afford them additional risk cover. Investor preference was, additionally, for fixed rate lending, notwithstanding the accumulation by Cashbank of floating/variable rate assets.

- A number of prospective participants expressed doubt over the timing of the payments by USAID in respect of default process. While it may be that they have no experience of the timing of a USAID payment in terms of this facility, the terms of ARTICLE III, Section 3.01 (b) require that the loan be placed on a “non-accrual” (of interest) basis. In the event that payments under this facility are delayed, this represents a potential loss of interest of a quantum unknown to the investor. *Consideration should be given to stating the maximum period that USAID will take to make a payment under a correctly constituted claim, and the event that payment is not made within that stipulated, penalty interest will accrue to the claimant. While consultant agrees that incorrect documentation submitted in support of a claim can delay processes, the wording of the sections 3.03 and 3.04 of ARTICLE III is sufficiently obtuse and non-defined so as to allow an open-ended period for performance by USAID.*

- Consultant was advised that certain respondents considered the claims procedure an administrative burden. While consultant cannot comment on this assertion, in some areas the documentation remains silent on specific issues regarding claims and claims procedures. *It is suggested that the wording of clause 3.01 (b) be amended to :The Guaranteed Party submits, concurrent with the document in (a) above, a confirmation, from the registered auditors of the Guaranteed Party, that a provision for a loan loss has been created in the accounting records of the Guaranteed Party, and that, subject to the terms and conditions of the Guarantee, interest on such loan has been placed in suspense.*

- Respondents in some instances found the “risk-sharing” nature of the USAID DCA programme unacceptable, and suggested instead that the security provided be constructed in such a way that USAID underwrote the FIRST 50% of the risk, where after the prospective investors would be placed at risk for the balance.

Certain of the “concerns” and “issues” raised by the prospective investor market cannot, on the basis of commercial decisions, be comprehended by consultant. Based on prior experience in both the risk evaluation and control environment, consultant is of the opinion that most respondents who proffered these concerns consider the risk of default to be very high. It cannot be argued that the financial performance (and consequent internal capital generation) of Cashbank has been weak, and it is consultants opinion that the underlying concern with respondents was the longevity of the bank.

SECTION THREE

Consultant, in conjunction with Cashbank and USAID, was required to identify potential investors and to hold discussions to determine their interest. Two issues, in the opinion of consultant, mitigate against this course of action at this time. Firstly, Cashbank is in the process of constructing a transaction in conjunction with SCMB that seeks to provide a warehouse/overdraft facility, subsequently able to be rolled into a note programme anticipated to total some R 650 million (in conjunction with assets held by Gateway Home Loans) in what can only be described as a multi-seller Securitisation-type programme. Cashbank are required to provide Credit Enhancement to a level of 10% of the programme, which participation will, in accordance with the requirements of the Banking Regulator, be impaired. This programme, from closing, provides a period of some 9 months during which Cashbank are able to maintain normal operational procedures and disbursements. Based on the largely negative response received by Cashbank to the USAID DCA programme, it is consultants opinion that the SCMB programme currently enjoys preference. However, based on consultants knowledge of the issues and difficulties facing a transaction of this nature, the closing thereof may be delayed beyond the expectations and requirements of the participants. Secondly, the (low income market) sector as a whole currently faces extremely negative perceptions in the investor market, and a re-approach to the market at this stage could prove extremely counter-productive. In addition, consideration needs to be given to the earlier product amendments suggested in order to potentially enhance investor perceptions of the timely role that can be played by USAID. The identification, and possible contingent contracting, of a standby service agent also needs to be considered.

SECTION FOUR

Consultant has been asked to consider examining amendments to the DCA product in order to find a suitable investor. Based on the responses of the investors approached by Cashbank, consultant is of the opinion that the stated reasons behind their decision not to participate in the programme could not be ascribed to patent difficulties with the programme, but a result of concern that the risk of failure by Cashbank was extreme, and that to incur a zero loss was infinitely preferable to incurring a 50% loss. Notwithstanding, the concerns regarding timing indicate that investor knowledge of the process that underpins the programme is deficient, and consideration needs to be given to eliminating such deficiency.

Consultant is further of the opinion, and this opinion carries the concurrence of Cashbank, that a shortening of the maturity period of the programme would not, at this stage, change the perceptions of the investor market.

In summary, Cashbank is one of very few Financial Institutions that offer long term housing finance to the lower income/previously disadvantaged sector. While it appears that this may change going forward, the real lack of access to collateral realisation, the influence of extraneous (social) issues that may lead to default within the collateral pool, relative economic stagnation and high unemployment within this sector (coupled with the need to support newly unemployed family members) and the uncertainty that lending institutions face in exploratory markets mitigate against even partial risk being taken in this instance. This uncertainty has been, partially, mitigated by other market participants through shorter duration lending, and a strict focus on external security in the event of default. It is generally held that most Financial Institutions have not exerted themselves in this direction, a decision that while probably socially questionable, has economic support. To anticipate indirect exposure, as would be the case with participation in the Cashbank/DCA programme, further exposes them to unknown issues such as administrative capacity and underwriting standards.

The current participation of SCMB in the creation of a multi-seller programme is a direct result of another participant in this market failing to perform to expectations. Consultants exposure to this market clearly indicates that ANY form of unknown risk to investors at this stage is not likely to be considered. The use of project/structured finance mechanisms to overcome these unknowns are currently being developed, and provided that they are formally explained to investors, may serve to alleviate the unknown qualities of investments in this sector. Consultant is of the opinion that the USAID programme will be able to play a role in providing credit enhancement to such developments, albeit not directly in the current form of the programme. However, until such time as such structures are open to public scrutiny, consultant is unable to form an opinion on the amendments, if any, that will be required to the DCA programme.

Michael J Berry